...MITTED Jan 12 27

# Petition and Transcript of Record

## Supreme Court of the United States

OCTOBER TERM, 1927

## No. 162

SAMUEL J. KORNHAUSER, PETITIONER,

*vs.*

THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

PETITION FOR CERTIORARI FILED JANUARY 12, 1927

CERTIORARI GRANTED APRIL 11, 1927

(22,396)

(32,396)

# SUPREME COURT OF THE UNITED STATES

## OCTOBER TERM, 1926

## No. 829

SAMUEL J. KORNHAUSER, PETITIONER,

*vs.*

THE UNITED STATES.

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

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JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., JANUARY 24, 1927.

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# IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1926

No. 829

SAMUEL J. KORNHAUSER, Petitioner,

v.

UNITED STATES OF AMERICA, Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS. — Filed January 12, 1927

To the Honorable Supreme Court of the United States:

Your petitioner, Samuel J. Kornhauser, by his attorney and counsellor, respectfully prays for a writ of certiorari to review the judgment of the United States Court of Claims in the above entitled cause.

## Question Involved

The petitioner paid for the calendar year 1918 what he alleges to have been excessive income taxes arising through the refusal of the Commissioner of Internal Revenue to per [fol. b] mit him to deduct from his gross income for that year the sum of ten thousand dollars ($10,000.00), being the amount paid by the petitioner during the year 1918 for attorneys' fees expended by petitioner in defending in the courts of the State of Ohio an action against him for an accounting instituted by his former copartner, the said action growing directly out of the conduct of the business of petitioner and his former copartner in the practice of law in the City of Cleveland in said State, it having been alleged by petitioner's said copartner that petitioner had collected fees or compensation for professional services performed during the existence of the copartnership, to a division of which the said copartner claimed to be entitled. The said copartner charged that subsequent to the dissolution of the partnership your petitioner had received cer-

tain fees consisting of stock in the National Tool Company in payment for legal services performed during the existence of the partnership. Your petitioner resisted successfully the claims of his former copartner throughout all the courts in Ohio, wherein the case was heard and the said expense which he paid his attorneys was claimed by your petitioner as a necessary expense incurred in connection with his business within the meaning of sub paragraph (1) of Section 214 (a) of the Revenue Act of 1918 or else a loss incurred in connection with his business within the meaning of sub paragraph (4) of said Section 214 (a) and in either event deductible from his gross income within the purview and meaning of the Revenue Act of 1918 for the purpose [fol. 6] of determining his net income upon which his liability for taxes depends.

The Court of Claims holds that the payment of these attorneys' fees was neither a necessary expense arising or resulting from the carrying on of the petitioner's business nor that it was a loss incurred in or resulting from the carrying on of any business by the petitioner, but that the payment of these attorneys' fees comes within the purview of Section 215 of the Revenue Act of 1918 which provides that in computing net income no deduction shall be allowed in respect of personal, living or family expenses.

## Reasons Relied on for the Allowance of the Writ

The writ herein sought should issue for the following reasons:

1. The Court of Claims has decided an important question of Federal law which has not been, but should be, settled by this Court.

2. The decision of the Court of Claims tends to place attorneys' fees paid unwarily and unnecessarily incurred by a taxpayer in defending himself in connection with a matter arising directly out of the business in which he was engaged in the category of a subsidiary personal expense, thus discriminating in the character of expenses that a taxpayer may incur or a loss which he may suffer resulting from [fol. 7] the carrying on of his business.

3. The effect of the decision of the Court of Claims is to penalize a taxpayer who undertakes to defend himself against a spurious claim arising in connection with the business in which he is engaged.

4. The Court of Claims has decided a question of Federal law in a way which seriously affects the inherent rights of every citizen of the United States who is engaged in business and subject to the payment of Federal income taxes.

5. This Court has granted at this term, to wit, on October 11, 1926, a petition for certiorari to the Circuit Court of Appeals for the Third Circuit in the case of Lewellyn, Collector, v. Electric Reduction Company, No. 294, October Term 1926, wherein there is involved one of the vital questions arising in this case, namely, what constitutes a loss sustained in carrying on a trade or business? Neither that question nor the other questions involved in the present petition have been passed upon by this Court.

Wherefore your petitioner respectfully prays that a petition for a writ of certiorari to review the judgment of the Court of Claims be granted.

L. L. Hamby, Attorney for Petitioner.

[fols. 6 & 7] DISTRICT OF COLUMBIA, ss:

L. L. Hamby, being first duly sworn, states that he is the attorney and counsellor for the petitioner named in the foregoing petition and has particular knowledge of the matters and things set forth therein and of the proceedings in the above entitled action; that he has read the foregoing petition subscribed by him and knows the contents thereof, and that the facts therein stated are true.

L. L. Hamby.

Subscribed and sworn to before me this 12th day of January, 1927. Lucille C. Stone, Notary Public, D. C. My commission expires January 30, 1929. (Seal Lucille C. Stone, Notary Public, District of Columbia.)

I hereby certify that I have read the foregoing petition and that in my judgment the petition is well founded as to matters of fact and as to matters of law, and that the case identified thereby is one, and is such, that the prayer of the petitioner should be granted by this Honorable Court.

L. L. Hamby, Attorney and Counselor for the Petitioner.

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[fol. 1] In Court of Claims of the United States

No. E-343

Samuel J. Kornhauser

vs.

The United States

I. History of Proceedings

On October 22, 1925, the plaintiff filed his original petition.

On December 21, 1925, the defendant filed a demurrer to said petition.

On January 12, 1926, the demurrer was argued and submitted by Mr. J. H. Sheppard, for defendant, there being no appearance for the plaintiff.

On February 1, 1926, the court, in an opinion by Campbell, Ch. J., sustained the demurrer and dismissed the petition.

On March 27, 1926, the plaintiff filed a motion to vacate judgment and for re-hearing and for leave to file an amended petition, which amended petition was presented with the motion.

On April 12, 1926, the court entered the following order on said motion:

Order

In this cause the plaintiff having made a motion to file an amended petition, it is ordered by the court this 12th [fol. 2] day of April, 1926, that its former order dismissing the petition be and it is vacated, and the plaintiff has leave within thirty (30) days to file an amended printed petition.

H. AMENDED PETITION—Filed April 12, 1926

To the Chief Justice and Associate Justices of the Court of Claims:

Your petitioner, Samuel J. Kornhauser, respectfully represents to your Honors:

I

That he is a citizen of the United States and a resident of Cleveland, State of Ohio; that he duly filed his income tax return for the calendar year 1918, as provided by the Revenue Act of 1918 in which said return he claimed as a deduction from his gross income the sum of $10,000, being the amount paid by him during the said year 1918 for attorney's fees incurred in defending in the courts in the State of Ohio an action against him for an accounting instituted by his former co-partner, said action growing directly out of the conduct of the business of himself and his co-partner in the practice of law in said City of Cleveland in the State of Ohio, it being alleged by his said co-partner that your petitioner had collected fees or compensation for profes-
[fol. 3] sional services performed during the existence of the said co-partnership, to a division of which the said co-partner claimed to be entitled; that the alleged fees in fact consisted of stock in the National Tool Company which was acquired by this petitioner subsequent to the dissolution of said partnership and not in any manner in payment for legal services performed during the existence of said partnership; that your petitioner was successful in the defense of the said and throughout all the courts wherein the case was heard and finally determined and the said expense so incurred your petitioner believed and alleges was a necessary expense incurred in connection with his business within the meaning of sub-paragraph (1) of Section 214 (a) of the Revenue Act of 1918 or else a loss incurred in connection with his business within the meaning of sub-paragraph (4) of said Section 214 (a) and in either event was deductible from his gross income within the purview and meaning of the Revenue Act of 1918 in determining the amount of his net income upon which his income tax liability was to be determined, since it was paid out during

that year and not compensated for by insurance or otherwise.

II

Notwithstanding the facts as hereinbefore set forth, the Commissioner of Internal Revenue refused to permit your petitioner to have the aforesaid deduction and by virtue thereof his gross income and his net income were increased by that amount which resulted in an assessment against him by the said Commissioner of an additional tax due directly thereto in the amount of $1,126.15, which upon demand of the Collector of Internal Revenue at Cleveland, Ohio, was paid on, to wit, March 24, 1924, to the Collector [fols. 4-6] of Internal Revenue at Cleveland, Ohio, and which amount has subsequently been paid over to or covered in the Treasury of the United States.

Your petitioner on, to wit, the twenty fourth day of March, 1924, duly filed with the Commissioner of Internal Revenue his claim for a refund of the said taxes but the said Commissioner did on, to wit, September 22, 1924, reject the said claim.

III

Your petitioner further avers that he has not in any way aided, abetted or given encouragement to rebellion against the United States, that the facts set forth herein are true; that he was never assigned the said claim nor any part thereof but has always been and is now the sole owner thereof, and that he is justly entitled to recover of and from the United States the sum of $1,126.15 together with interest thereon from March 24, 1924.

Wherefore, the premises considered, your petitioner prays judgment against the United States for the sum of $1,126.15 with interest as aforesaid.

Samuel J. Kornhauser, Plaintiff. L. L. Hanby, Attorney for Plaintiff.

*State* [illegible] *to by Samuel J. Kornhauser. Jurat omitted in printing.*

[fol. 7] III. Demurrer—Filed May 27, 1926

Comes now the Assistant Attorney General in behalf of the defendant and demurs to plaintiff's amended petition on the ground that—

Plaintiff has not set forth a just and legal cause of action against the United States.

Herman J. Galloway, Assistant Attorney General.
Joseph H. Sheppard, Attorney.

IV. Argument and Submission of Demurrer

On October 25, 1926, the demurrer to the amended petition in this cause was argued by Mr. J. H. Sheppard, for the defendant, and by Mr. L. L. Hamby, for the plaintiff.

[fol. 8] V. Opinion of the Court by Moss, J., Sustaining the Demurrer and Dismissing the Amended Petition—Entered November 16, 1926

Moss, Judge, rendered the opinion of the court:

It is alleged by plaintiff in his original petition that in his income-tax return for the calendar year 1918 he claimed as a deduction from his gross income for that year the sum of $10,000, being the amount paid by him for attorney's fees incurred in defending an action against himself for an accounting instituted by his former law partner, in which action it was charged that plaintiff had collected fees for professional services during the existence of the partnership in which his said law partner was entitled to share. The Commissioner of Internal Revenue refused to allow the deduction.

A demurrer was sustained to the original petition, and on plaintiff's motion the court entered its judgment dismissing the petition and granted plaintiff leave to amend.

An amended petition was filed which contains in addition to the matters alleged in the original petition the following language:

"4. [illegible] that the alleged fees in fact consisted of stock in the National Tool Company which was acquired by this petitioner subsequent to the dissolution of said partnership and not in any manner in payment for legal services performed during the existence of said partnership."

The case is now submitted on demurrer to the amended petition and the question for determination is whether or not fees paid to an attorney for defending an action for an accounting instituted by a former law partner may be deducted by the taxpayer from his gross income in making his tax return.

Plaintiff contends that the expenditure is deductible, either as an ordinary and necessary expense in connection with his business under the provision of section 214(a) of the revenue act of 1918, 40 Stat. 1066, which allows deductions for "All ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business"; or else it is deductible as a loss under paragraph 4 of said section which provides for deductions for [fol. 9] "Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business."

The expenditure in question is not an allowable deduction under either provision.

The payment of a fee for legal services under the conditions alleged in the original and the amended petitions is neither an ordinary nor necessary expense incurred in carrying on the trade or business, nor is it a loss sustained in trade or business in the meaning and intent of the statute.

It is a personal expense, and is controlled by section 215 of the same act, which provides, "That in computing net incomes no deduction shall in any case be allowed in respect of—(a) Personal, living, or family expenses."

The amendment, which merely describes the character of the fee, does not in any manner affect the question of law as presented in the original petition.

The demurrer should be sustained and the petition and the amended petition should be dismissed. And it is so ordered.

Graham, Judge; Hay, Judge; Booth, Judge; and Campbell, Chief Justice, concur.

[fol. 10] VI. JUDGMENT

At a Court of Claims held in the City of Washington on the Sixteenth day of November, A. D., 1926, judgment was ordered to be entered as follows:

This case was submitted upon the defendant's demurrer to the plaintiff's petition as amended; on consideration whereof the court is of opinion that the demurrer is well taken. It is therefore adjudged and ordered that the defendant's said demurrer be sustained and that the petition, as amended, be and the same is hereby dismissed.

By the Court.

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[fol. 11] Clerk's certificate to foregoing transcript omitted in printing.

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Endorsed on cover: File No. 32,336. Court of Claims. Term No. 829. Samuel J. Kornhauser, petitioner, vs. The United States. Petition for writ of certiorari and exhibit thereto. Filed January 12th, 1927. File No. 32,336.

(4494)

SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed April 11, 1927

The petition herein for a writ of certiorari to the Court of Claims is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

(6640)

Office Supreme Court, U. S.
FILED
FEB 18 1927
WM. R. STANSBURY
CLERK

IN THE

# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1926.

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No. [redacted] 162

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SAMUEL J. KORNHAUSER, PETITIONER,

*v.*

UNITED STATES OF AMERICA, RESPONDENT.

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## BRIEF ON BEHALF OF PETITIONER IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

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L. L. HAMBY,
*Attorney for Petitioner.*

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1926.

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# No. 829.

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SAMUEL J. KORNHAUSER, PETITIONER,

*v.*

UNITED STATES OF AMERICA, RESPONDENT.

---

## BRIEF ON BEHALF OF PETITIONER IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

---

### Statement of the Case.

The primary question presented by the petition filed herein has arisen from the decision of the Court of Claims which holds that the amount expended by the petitioner in the year 1918 in payment of the fees of an attorney for defending him in a suit for an account

ing in the courts of the State of Ohio, wherein the plaintiff alleged that this petitioner had collected fees to a division of which the plaintiff claimed to be entitled, was not deductible by petitioner from his gross income in computing the tax upon his net income according to the purport and intent of the Revenue Act of 1918.

The case was submitted in the court below on a demurrer to the amended petition, wherein petitioner was the plaintiff and respondent the defendant. The facts set forth in the said amended petition are therefore admitted to be true.

The court below sustained the demurrer and dismissed the amended petition; wherefore the petition for a writ of certiorari herein was filed.

## The Facts

Stated briefly, the only material facts are as follows: A suit for an accounting was instituted in the courts of Ohio against petitioner by his former law partner, who alleged therein that subsequent to the dissolution of the copartnership petitioner had collected as a fee for legal services performed while the partnership was in existence certain stock in the National Tool Company, to an accounting for which the plaintiff claimed to be entitled. The said stock was not received by petitioner in payment for legal services performed while the partnership was in existence, and he successfully defended in the courts of Ohio the suit brought by his former copartner, and at the conclusion

thereof, in the year 1918, paid the attorney who defended him a fee of ten thousand dollars ($10,000).

**Pertinent Provisions of the Statute to be Interpreted.**

Under the heading "Deductions allowed" of Title II of the Revenue Act of 1918, the statute provides as follows:

> "SECTION 214 (*a*). That in computing net income there shall be allowed as deductions:
>
> "(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *
>
> "(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;
>
> "(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *"

Immediately after the foregoing provisions, the statute provides, under the heading entitled "Items not deductible," as follows:

> "SECTION 215. That in computing net income no deduction shall in any case be allowed in respect of—
>
> "(*a*) Personal, living, or family expenses;
>
> "(*b*) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

"(c) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; or * * *."

## ARGUMENT.

Petitioner contends that the amount expended by him was deductible under paragraph (1) or (4) or (5) of Section 214 (*a*) above, but the court below has held that it was not deductible because it was an expenditure coming within the provisions of paragraph (*a*) of Section 215 above.

This is an important question of Federal law which has not been, but which petitioner believes should be, settled by this Court.

Furthermore, the court below has placed the expenditure in this case in the category of a voluntary personal, family, or living expense, and thus attempted to discriminate in the character of expenses that a taxpayer may incur under the provisions of paragraph (1) of Section 214 (*a*), and likewise in the character of the loss which a taxpayer may suffer within the provisions of paragraphs (4) and (5) of Section 214 (*a*). Petitioner believes that this contravenes the intention of those provisions.

The effect of the decision of the court below is to penalize petitioner for defending himself, for, had he acceded to the demands, the amount so expended would ordinarily have been deductible from his gross income and in a much larger amount.

The question involved in this case from its very nature seriously affects inherently the rights and liability of every citizen of the United States who may be engaged in business and subject to the payment of income taxes.

## What is a Necessary Business Expense?

It cannot be doubted that, had not petitioner been engaged in business with his former copartner, the suit for an accounting could not have been instituted. The expense of defending himself, therefore, was incurred primarily and exclusively because of his business and was a necessary expense within the meaning of paragraph (1) of Section 214 of the statute. The petitioner having not acceded voluntarily to the demands of the suit, the expense of defending it was involuntarily and unavoidably incurred, hence necessary.

The whole of the Revenue Act under consideration is a statute which deals exclusively with the imposition of a tax imposed upon income, gain, or profit, and not with things which bear no relation thereto.

The Treasury Department, in an official document entitled "Cumulative Bulletin No. 2," at page 157, sets forth, as Decision No. 451, in regard to its construction of paragraph (1) of Section 214 (*a*) (*supra*), the following:

> "The test is whether an expense is incurred primarily because of business as the immediate cause of incurring the expenditure."

Can it be seriously contended that the expense of defending a suit for an accounting, arising solely out of the conduct of one's business, is other than one coming directly within this test?

In Cumulative Bulletin No. 3, a similar official document issued by the Treasury Department, there appears, on page 121 thereof, the Department's decision in a case, the material portions of which are as follows:

> "A tenant at work on the farm of a taxpayer was injured. In defending suit for damages on account of negligence, the taxpayer incurred expenses for attorney's fees.
>
> "It is held that if the taxpayer was engaged in farming he was carrying on a trade or business, and that the attorney's fees constituted compensation for personal services actually rendered, which is deductible as an *ordinary* and *necessary* expense. If the farm was rented, the amount so paid is deductible as a business expense incident to the carning of the rent" (Sec. 214(a), (1). (Italic letters ours.)

The foregoing references to the decisions of the Treasury Department are cited merely for the purpose of indicating the contemporaneous executive construction of the particular section of the statute herein considered.

It is a matter of common knowledge that railroads, manufacturers, and industrial companies, as well as individuals and firms, are called upon to defend suits against them relating to the business in which they are engaged. Many of these claims are spurious, many of

them wholly or partly justifiable, and others unjustifiable. They must be defended, however, or else the demands must be met. If they are not defended, the amount paid would generally be far in excess of the amount which attorneys would charge to defend such claims, and thus the resulting net income would be reduced *pro tanto*. If this were not generally true, the legal profession would truly be an unnecessary evil. By defending such suits, one is enabled to conserve as much as possible of his net income, which redounds to the profit of the Government in the imposition of the tax upon his income. Because one should undertake to defend himself and thus conserve more of his net income than he would conserve should he accede to demands made against him, and thus enable him to report a larger net income, must he be penalized by being told that the cost of his defense was neither a necessary expense nor a loss, and that he shall pay taxes upon this amount so expended and not deduct them? Such a situation would seem anomalous.

### What is a Loss Arising from Business?

Let us now briefly consider, not alternatively nor disjunctively, but conjunctively, whether the amount expended by petitioner was a deductible loss contemplated in paragraph (4) of Section 214(a) of the statute. If the loss were incurred in trade or business and not compensated for by insurance or otherwise, it is deductible.

The petitioner did not voluntarily make this expenditure as an investment for the purpose of acquir-

ing any property, but involuntarily in defense of a spurious claim for an accounting. The amount so expended was a total loss, the antithesis of an investment, and it cannot be recovered, nor was the petitioner compensated therefor by insurance or otherwise.

There is still another reason why the expenditure should be deducted. If the expenditure were incurred in any transaction entered into for profit, though not connected with the trade or business, it is deductible, if not compensated for by insurance or otherwise, under the provisions of paragraph (5) of said Section 214(*a*).

The transaction by which petitioner received the fee, to which the suit against him related, could scarcely be termed other than a transaction entered into for profit, since lawyers do not customarily engage in business for pleasure alone. The statute does not attempt to define the kind of transaction which shall be entered into for profit, and therefore it was without limitation.

**Items Not Deductible.**

The court below in its opinion has held that the expenditure in this case is controlled by Section 215 of the statute, which, as hereinabove referred to, provides:

> "That in computing net income no deduction shall in any case be allowed in respect of—
>
> "(*a*) Personal, living or family expenses" (Rev. 8).

The court in its opinion gives no reason for holding that the expenditure in this case comes within the

above quoted provisions of Section 215 other than to say that it is a personal expense, nor does it give any reason why it is not deductible under paragraphs (1) or (4) of Section 214(*a*) other than to say that the amount expended was neither a necessary expense in carrying on a trade or business nor a loss sustained in trade or business within the meaning of the statute (Rec. 8).

The Treasury Department, in Article 291 of Regulations 45, promulgated under the Revenue Act of 1918, enumerates various items which are intended as illustrations of the character of expenses which are personal and not deductible. These are such expenses as insurance paid on a dwelling in which one *lives* (not one rented for profit), life insurance, and rent of a house in which one lives. In each of these instances there is a direct connection between the expenditure and the taxpayer's person, or his home, or his family. All expenditures made by an individual are in a sense personal, because they are made by the individual and no one else. We interpret the meaning of Sections 214 and 215 of the statute, considered together as successive provisions of the statute, to be that if the expenditure by an individual, which must of necessity be *personal*, arise in connection with or as the direct result of engaging in *trade* or *business*, not involving the making of an investment resulting in the acquisition of property, it is deductible; but if the expenditure did not arise because of his engaging in business, but, on the contrary, should bear no relation to his business or trade, it is not deductible. The reason why it is not

deductible in the latter instance is because the expenditure was not incurred in regard to anything which affects the business of earning income. The familiar doctrine *noscitur a sociis* is peculiarly applicable in interpreting what was meant by the expression "personal, family or living expenses." In applying this doctrine, the word "personal" means an expenditure relating to the person himself, and not the business in which he is engaged, and contemplates expenditures for clothing, recreation and amusement, and the innumerable other expenses in which a person may indulge voluntarily for pleasure or because of a duty. A family expense we interpret to mean one which a person incurs on behalf of his family unrelated to his business. It may be for the support of his family in the purchase of food and clothing or it may be for amusement or recreation of his family or medical attendance or any other expense relating to the person. A living expense we interpret to mean one which is incurred in defraying the cost of subsistence of the person or the subsistence of the person's family. In interpreting the statute, as well as applying the doctrine to which we have referred, we must give the language used in the statute its ordinary, everyday meaning, and not apply some possible definition of the words which may be foreign to the context.

It seems clear, therefore, that Section 214, preceding as it does Section 215, contemplates the allowance of all deductions expenditures made by individuals if they relate or directly bear upon his business or trade, and do not involve the acquisition of property as a

capital investment, and that Section 215, following as it does, contemplates excluding as deductions (*a*) only those personal expenditures of an individual which relate to his person, the subsistence of his person and his family, and (*b*) expenditures in the nature of capital investments, although connected with the business of the individual.

Thus (*b*) of Section 215 seems to be in the nature of a limitation or exception to the provisions of Section 214, and therefore to be strictly construed, for, were it not for the provisions of paragraph (*b*) of Section 215, the expenditures therein contemplated may have been deductible as an expense incurred in carrying on a trade or business.

The application of paragraph (*b*) of Section 215, relating to items not deductible, is well exemplified in the decision of the U. S. District Court for the Southern District of New York in the case of Laemmle *v.* Eisner, 275 Fed., 504. In this case the decision of the court is embraced in one sentence, which is as follows:

> "After a full consideration of the facts of this case, I am constrained to the view that the sum of attorney's fees paid in the litigation *for the purpose of the Horsley stock, resulting in practically the ownership or control thereof and the consequent management of the company, under the facts and circumstances disclosed by the record*, constituted a capital investment, and not a 'necessary expense actually paid in carrying on the business,' deductible from income derived from such business." (Italic letters supplied.)

In this case it is perfectly obvious that the expenditure was not incurred in carrying on any trade or business or as the result of anything of that sort, but, on the contrary, it constituted an expenditure incurred in connection with an effort to procure the mastery of the stock of a certain company, which would result in the practical ownership and control thereof. No question of a loss was or could be involved in this case, since the facts recited by the court, and upon which its decision was based, show that Laemmle, in his effort to control the stock of the company and gain the management thereof, induced one Horsley to sell him the stock coveted by an option held by another person. This other person brought a suit against Laemmle and the Universal Film Manufacturing Company to enforce his right under the option. No trial was ever had, but, instead, a settlement was reached whereby the stock in question was divided by agreement among the parties in such a manner that Laemmle finally succeeded in retaining control of the company. His attorneys effected this settlement for him, and the amount of the fees paid these attorneys was claimed as a necessary expense. The court held that, in the circumstances of the case, the attorneys' fees were incurred primarily for the purpose of acquiring an investment and not in defense of any matter arising in connection with the carrying on of any trade or business of the plaintiff. Obviously, the business of the Horsley company was not the business of Laemmle, but in the case at bar your petitioner was defending an action against him in connection with

a suit for an accounting, arising over what was alleged to be fees earned in connection with the business carried on by petitioner.

It is not difficult to perceive that, where an individual desiring to acquire what he considers to be a valuable parcel of real estate as an investment employs a real-estate agent or an attorney to devise a plan whereby he can accomplish the ownership of such property as an investment, the commissions paid or the fees paid, if successful, are neither ordinary nor necessary expenses incurred in any trade or business in which he is engaged, nor do they constitute a loss similarly incurred, but rather an expenditure in aid of acquiring an investment and, as such, is added to the cost of the property so acquired as a part thereof.

In order to distinguish clearly between the intent of paragraph (a) of Section 215 and paragraphs (1) and (4) of Section 214, application of only the simplest logic is required to determine which of these sections applies to the case of this petitioner. It is quite plain that the amount expended by the petitioner was a loss, and that it was not compensated for by insurance or otherwise. If it were such a loss, it could not come within the category of a personal, family, or living expense, because neither in the ordinary nor in any extraordinary meaning of the word "loss" could it ever be said that money expended by one to afford himself or his family amusement, recreation, shelter, food, clothing, or medical attention constitutes a loss. There is not a solitary item of expenditure that one could

conceive as coming within the category of those embodied in Section 215 (a) which by any stretch of the imagination could be termed a loss, nor could such an expenditure even come within the category of an ordinary or necessary expense incurred in a trade or business; yet, if the expenditure in this case was in any respect a loss not compensated for by insurance, or if it were a necessary expense arising primarily as the result of engaging in any trade or business, it cannot be placed in the category of a personal, family, or living expense.

## Electric Reduction Co. Case.

Attention is invited to the case of Electric Reduction Company v. Llewellyn, 11 Fed. 2d Series, 493, in which this Court, at the present term, granted a petition for a writ of certiorari, being No. 394, October term, 1926, the writ being directed to the Circuit Court of Appeals for the Third Circuit, which had reversed the judgment of the District Court for the Western District of Pennsylvania. The question involved in that case was whether an amount sought as a deduction was deductible as a bad debt ascertained to be worthless during the taxable year and charged off as such, or whether it was deductible as a loss incurred in carrying on a trade or business. In so far as the question of deductibility as a bad debt is concerned, the case bears no similarity to the case of your petitioner, which does not involve that question. The district court held that the amount sought to be deducted was a bad debt, and, as it was

not ascertained to be worthless in the year in which it was deducted, it was not an allowable deduction. The circuit court of appeals held that the amount sought to be deducted was, under the broad provisions of the statute, a loss, and, as such, was deductible in the year in which the loss occurred. The facts in your petitioner's case are not to any extent similar to those in the case cited, but the loss sustained is not only so fully a loss as that in the case cited, but, unlike that case, it is not subject to any restrictions to which a deduction for bad debts is restricted. It follows that, if in the case cited the amount expended is held by this Court to be a loss, the expenditure in this case would obviously be deductible. On the other hand, if the expenditure in the case cited be not held to be a loss, but to be a bad debt subject to the restriction for deduction of bad debts, the right to deduction in the case of this petitioner would still be left undetermined by this Court.

Wherefore it is earnestly urged that the petition for a writ of certiorari herein be granted.

L. L. HAMBY,
*Attorney for Petitioner.*

Supreme Court, U. S.
FILED
MAR 28 1927
WM. R. STANSBURY
Clerk

IN THE

# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1926.

No. 162

SAMUEL J. KORNHAUSER, Petitioner,

v.

THE UNITED STATES.

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

## PETITIONER'S REPLY BRIEF.

L. L. HAMBY,
*Attorney for the Petitioner.*

IN THE

# SUPREME COURT OF THE UNITED STATES

**OCTOBER TERM, 1926.**

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## No. 829.

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SAMUEL J. KORNHAUSER, PETITIONER,

*v.*

THE UNITED STATES.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

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## PETITIONER'S REPLY BRIEF.

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Respondent has interposed several objections to the granting of the writ herein sought. To these objections only the briefest reply seems necessary.

I.

Respondent states on page four of its brief that no question of importance to taxpayers in general is in-

volved in this case, although it may be important to petitioner. Every citizen of the United States who is engaged in business is liable to be sued. Can it be doubted, then, that it is a matter of greatest importance to them whether attorneys' fees paid in defending a suit arising in connection with their business may be deducted from their gross income in computing the Federal income tax? The question, therefore, is not alone important to the petitioner but to everyone similarly involved.

Respondent states that claim for a deduction of this kind is an exception rather than a rule. It may be said that the loss of property by one, as the result of storm or fire, is an exception rather than a rule; but the same revenue act allows deduction for such loss. Is it to be denied because exceptional? The test does not seem to be whether it is exceptional, but whether the provisions of the law contemplate the deduction.

## II.

On page four of its brief respondent states that attorneys' fees paid out in defense of the suit in this case did not affect petitioner's business as the partnership had already been dissolved and regardless of the decision in the suit, the income of the partnership was neither enhanced nor diminished. This case does not relate to any tax on a partnership, for the revenue act in question imposed no taxes upon partnerships, but only upon the individual members; furthermore, the suit was brought against this petitioner and the

attorney's fee was paid by him after the partnership had been dissolved, as respondent admits.

III.

Respondent next argues, at the bottom of page four and the top of page five of its brief, that the expense or loss was not incurred or sustained within the meaning of the words "in trade or business" as used in the Revenue Act of 1918, and for a definition of those words the case of Mente *v.* Eisner, 266 Fed. 161, is cited. The merest glance at this case shows that it arose not under the Revenue Act of 1918, which controls this case, but under Section II, subdivision 2B of the Act of October 3, 1913 (38 Stat. 167), which provided that in computing net income there shall be allowed as a deduction:

> "4th, losses actually sustained during the year incurred in *trade* or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise." (Italic letters supplied.)

Mente was a member of the firm of Mente & Company, engaged in the *manufacturing* business, and as the court said in that case:

> "He had for some three years been buying and selling cotton on the Cotton Exchange for his individual account, in no way connected with the business of Mente & Co., and he deducted from his gross income in each year losses sustained in the year resulting from these transactions as 'losses incurred in trade.'"

The court on page 162 of its opinion took the view that the language "losses incurred in trade" were intended to mean losses in the actual business of the taxpayer which in that case was manufacturing and that his speculation in cotton futures on the side constituted an isolated transaction not connected with his trade. A strong dissenting opinion was filed.

Singularly, the 1918 Act permits deduction of the very thing which the court in the case cited disallowed under the earlier 1913 Act. Furthermore, the 1918 Act does not confine the deduction to losses or expenses sustained or incurred merely in trade but "in carrying on *any trade* or *business*." Your petitioner was engaged in the practice of law and surely it can not be contended that a lawyer is not engaged in business within the meaning of paragraphs (1), (2) and (3), Sec. 214(*a*) of the 1918 Act.

It will be seen, therefore, that the case cited is not analogous; that the statute involved therein is quite a different one; and finally that under the facts in the case cited the deduction would be allowed as a deduction under paragraph (5) of Sec. 214 of the 1918 Act, as the Treasury Department has uniformly held since the passage of that act.

IV.

Your petitioner has directed attention to the fact that this Court at the present term has granted a petition for a similar writ in a case which involves one of the two questions arising in this case relating to the meaning of the word "loss" as used in the Revenue

Act of 1918. We find no allusion to this in respondent's brief and therefore assume it to be admitted.

We think no valid objection to the granting of the writ has been interposed by the respondent and believe it should issue.

Respectfully submitted,

L. L. HAMBY,
*Attorney for the Petitioner.*

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# In the Supreme Court of the United States

OCTOBER TERM, 1926

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SAMUEL J. KORNHAUSER, PETITIONER

*v.*

THE UNITED STATES

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS*

---

## BRIEF FOR THE UNITED STATES IN OPPOSITION

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### OPINION BELOW

The opinion of the Court of Claims (R. 7–8) has not yet been officially reported.

### JURISDICTION

The judgment to be reviewed was entered November 16, 1926. (R. 9.) Petition for certiorari was filed January 12, 1927. (R. 9.) Jurisdiction to issue the writ is conferred by Section 3 (b) of the Act of February 13, 1925. (Ch. 229, 43 Stat. 936, 939.)

### THE QUESTION

The question presented is whether the amount of attorney's fees paid by petitioner for defense of an action for accounting brought against him by a

former law partner was a business expense deductible from gross income in computing net taxable income under the Revenue Act of 1918.

## STATEMENT

In this case the petitioner filed a suit in the Court of Claims for the refund of income tax. The Government demurred to the petition and the demurrer was sustained by the court. A review is now sought of such ruling. The petition alleged that the petitioner paid the sum of $10,000 to an attorney, as fees, for defending him in a suit for an accounting filed against him by his former copartner, it being claimed in said suit that petitioner had collected legal fees in which his said copartner was entitled to share. (R. 5.) The petitioner, in filing his tax return, claimed a deduction of the said $10,000 as an ordinary and necessary business expense or as a business loss.

The Commissioner of Internal Revenue denied the petitioner's claim and assessed and collected an additional tax of $1,126.15. A claim for refund of the tax was duly filed by petitioner and rejected by the Commissioner of Internal Revenue. (R. 6.)

The Court of Claims in sustaining the demurrer held that said payment of legal fees was not a necessary and ordinary expense in trade or business, but was a personal expense which was not deductible under the statutes.

## STATUTES INVOLVED

The sections of the Revenue Act of 1918 (Ch. 18, 40 Stat. 1057), involved herein are as follows:

> SEC. 214 (a). That in computing net income there shall be allowed as deductions:
>
> (1) All the *ordinary and necessary expenses* paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;
>
> * * * * *
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;
>
> (5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, *if incurred in any transaction entered into for profit*, though not connected with the trade or business; * * *.
>
> SEC. 215. That in computing net income no deduction shall in any case be allowed in respect of—
>
> (a) *Personal*, living, or family expenses * * *. (Italics supplied.)

## ARGUMENT

There is no important Federal question and there is no question of great importance to taxpayers in general involved in this case, even though the question may be important to the petitioner. A claim for a deduction of this kind is an exception rather than a rule. The language of the Revenue Acts setting out what are allowable deductions and what are not allowable deductions is plain and unambiguous and does not require construction by this Court.

It is argued by petitioner that the expense of defending the action was incurred primarily and exclusively because of his business with his former partner and that the expense was a necessary one within the meaning of Section 214(a)(1) of the Revenue Act of 1918. This argument is answered by the fact that the attorney's fee paid out in the defense of the suit did, in nowise, affect petitioner's business. The partnership had already been dissolved and, regardless of how the suit was decided, it would not enhance or decrease the income of the partnership. This expense was a personal one and was brought about by a personal action of the petitioner which was entirely separate and apart from any business transaction.

Petitioner next argues that the expense was a loss incurred in trade or business not compensated

for by insurance or otherwise. The expense was not incurred in trade or business within the meaning of the words " in trade or business " as used in the Revenue Act, but was incurred in an isolated transaction. For the definition of the words " in trade or business " as used in the Revenue Acts, see the case of *Mente* v. *Eisner*, 266 Fed. 161.

Petitioner further argues that he is entitled to a deduction of the attorney's fee expended by him in defending the suit under Section 214(a) (5) of the Revenue Act of 1918, for the reason that it was a loss incurred in a transaction entered into for profit. There is no merit to this argument for the reason that the transaction which brought about the loss, if there was a loss, was the law suit and it certainly cannot be argued that the plaintiff entered into a law suit brought against him for an accounting with the expectation of making a profit therefrom.

It appears that the expenditure sought to be deducted by the petitioner in this case can be nothing except a personal expenditure which was incurred by the petitioner by reason of the belief of his former law partner that the petitioner had committed some personal wrong against him; and that the decision of the Court of Claims in this case was correct.

In any event this case is not one justifying consideration by this Court, and the petition for writ of certiorari should be denied.

Respectfully submitted.

WILLIAM D. MITCHELL,
*Solicitor General.*
HERMAN J. GALLOWAY,
*Assistant Attorney General.*
JOSEPH H. SHEPPARD,
*Attorney.*

MARCH, 1927.

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# In the Supreme Court of the United States

OCTOBER TERM, 1927

No. 162

SAMUEL J. KORNHAUSER, PETITIONER

*v.*

THE UNITED STATES

*ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS*

## BRIEF FOR THE UNITED STATES

### OPINION OF THE COURT BELOW

The opinion of the Court of Claims (R. 7–8) is reported in 62 Ct. Cls. 647.

### GROUNDS OF JURISDICTION

The judgment to be reviewed was entered November 16, 1926. (R. 9.) Petition for certiorari was filed January 12, 1927. (R. 9.) Jurisdiction to issue the writ is conferred by Section 3 (b) of the Act of February 13, 1925. Petition for writ of certiorari was granted April 11, 1927 (47 Sup. Ct. 570).

### THE QUESTION

The question presented is whether or not moneys paid as attorney's fees in defending an action for an accounting brought against the petitioner by a former law partner were deductible from gross income in computing net income taxable for the year 1918.

### STATUTES INVOLVED

The sections of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1066, 1069, involved herein are as follows:

> SEC. 214 (a). That in computing net income there shall be allowed as deductions:
>
> (1) All the *ordinary and necessary expenses* paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;
>
> * * * * *
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;
>
> (5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, *if incurred in any transaction*

*entered into for profit*, though not connected with the trade or business; * * *.

SEC. 215. That in computing net income no deduction shall in any case be allowed in respect of—

(a) *Personal*, living, or family expenses; * * *. (Italics supplied.)

## STATEMENT OF THE CASE

This suit was instituted in the Court of Claims to recover the sum of $1,126.15, together with interest, which amount petitioner alleged had been erroneously assessed against and collected from him as income taxes for the year 1918. (R. 5–6.) A demurrer interposed by the Government to the petitioner's statement of claim was sustained. (R. 4.) An amended petition was filed, to which the Government also demurred. This demurrer was also sustained and the petition dismissed (R. 7), and a review is now sought of the Court's ruling in sustaining the Government's demurrer to the amended petition filed herein.

Petitioner, an attorney at law, alleges (R. 5) that in 1918 he paid the sum of $10,000.00 to an attorney as fees for defending an action brought against him in a state court of Ohio by a former law partner for an accounting, in which action it was alleged that certain shares of stock received by this petitioner in 1918 represented compensation for legal services performed during the existence of the partnership. Petitioner contends that the attorney's fee so paid was deductible from his gross income

in 1918 under subsection (a), (1), (4), or (5) of Section 214 of the Revenue Act of 1918, *supra*. The suit for accounting was successfully defended and judgment was rendered in petitioner's favor.

The court below in sustaining the Government's demurrer held that the attorney's fee expended in defending said action was a personal expense and that Section 215 (a) of the Revenue Act of 1918 expressly prohibited the claimed deduction. (R. 8.)

## SUMMARY OF THE ARGUMENT

It will be argued that the expenditure incurred by petitioner in defending an action for accounting brought against him by his former law partner was not such an expense as is deductible under the provisions of Section 214 of the Revenue Act of 1918, but that said attorney's fee was a personal or capital expenditure and that Section 215 of the Revenue Act of 1918 expressly prohibits petitioner from deducting such expense from his gross income for the year 1918.

## ARGUMENT

### THE ATTORNEY'S FEE PAID BY PETITIONER IN DEFENDING AN ACTION FOR AN ACCOUNTING BROUGHT AGAINST HIM BY A FORMER LAW PARTNER IS NOT DEDUCTIBLE

Congress, at the time of the passage of the Revenue Act of 1918, as well as other Acts, realized that all taxpayers would incur certain expenses in making an income and determined to allow taxpayers to reduce their taxes by allowing them to deduct certain expenses. The expenses to be deducted were

to be of a common nature to all taxpayers in proportion to the amount of income received by them. This is shown by the use of the words " ordinary and necessary" used in Section 214(a). On the other hand, Congress realized that there were certain expenses, such as personal, living, and family, which would not be in the same proportion as the income made, for some taxpayers lived on a larger percentage of their income.

All expenses to be deductible must come clearly within the provisions of Section 214.

Petitioner insists that the expense he is seeking to deduct comes within the provisions of Section 214 (a) of the Revenue Act of 1918, and that it was either an ordinary and necessary expense paid or incurred during the taxable year in carrying on a trade or business, or that it was a loss not compensated for by insurance or otherwise incurred in trade or business, or that it was a loss sustained in the taxable year and not compensated for by insurance or otherwise incurred in a transaction entered into for profit, though not connected with the trade or business.

Although there is some suggestion in the petitioner's brief that the transaction involved in this case constituted a "loss," which may be deducted from gross income under subsection (4) or (5) of Section 214 (a), it seems so clear that a payment for services rendered is not a "loss" within any definition of that word that to state the proposition

is to deny it. The conception of "loss" is negative receipt of value, for a loss presupposes something to be lost; it signifies destruction. Certainly the taxpayer did not lose the money he paid for legal services, for he received in return the services of his attorney, which it may be supposed aided the petitioner in securing a judgment in his favor in the State courts. It seems clear that there can be no "loss" here, for not only did the petitioner secure a judgment of the court for the money for which he was asked to account but his reputation, which was also involved in the case, was vindicated. The attorney's fee expended by the petitioner was nothing more than an *unusual* expense to which the petitioner was put in defending his personal property or reputation, or both. Again, it seems obvious from the reading of subsections (a), (4), and (5) of the Revenue Act of 1918 that Congress had in mind no such transaction as the one in this case, for the reason that it spoke of losses compensated for by insurance and losses incurred in any transaction entered into for profit where said transaction was not connected with the trade or business. It appears evident that if such an expense as the petitioner is claiming as a deduction could be brought within the meaning of a "loss" it was not such a "loss" as was capable of being insured, and it is just as evident that the taxpayer did not willfully engage in defending a lawsuit brought against him for an accounting of funds for the purpose of mak

ing a profit, but that he entered into the defense of such an action involuntarily for the purpose of preserving and making more secure his moneys or property already owned as well as for vindicating his reputation, which was at stake by the suit for an accounting.

The serious question in this case arises when it is sought to place this transaction on one side or other of the line drawn by the statute between "ordinary and necessary expenses paid or incurred in carrying on any trade or business" on the one hand, and "personal, living, or family expenses" on the other. This line is shadowy, for many transactions partake of the nature of both classes of expenses. Thus the transportation of one to his place of business may be said to be a business expense if approached from the viewpoint of necessity of conducting business at a given location. On the other hand, it may be said to be a personal expense when considered as arising from the personal choice of a dwelling place.

But manifestly the statute does not contemplate that one's point of view should determine the deductibility of expenses. Some more accurate and unvarying standard is undoubtedly intended. That standard, it is submitted, is the implications of words in the common understanding. The common understanding of the phrase "business expense" is very aptly described in the regulations promulgated by the Commissioner. The pertinent

part of Article 101 of Regulations 45 (1921 ed.) is as follows:

> *Business expenses.*—Business expenses, whether subtracted from total receipts in computing gross income or deducted from gross income in computing net income, include all items entering into what is ordinarily known as the cost of goods sold, together with selling and management expenses, except such classes of items as are treated in articles 121 to 268. Among the items to be treated as business expenses are material, labor, supplies, and repairs in the case of a manufacturer, while a merchant would include his purchases of goods bought for resale. In either case the amount to be taken as a deduction in any year should be determined by taking into consideration the inventory at the beginning and end of the year. Other items that may be included as business expenses are reasonable compensation for the services of officers and employees, advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident or other similar losses in the case of a business, and rental for the use of business property. But see article 294. A taxpayer is entitled to deduct the necessary expenses paid in carrying on his business from his gross income from whatever source.

Article 101 of Regulations 62 is practically the same as the above-quoted article.

The pertinent part of Article 101 of Regulations 65 is as follows:

> *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 121–251. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. (See article 35.) Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see article 102), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. But see article 293. A taxpayer is entitled to deduct the necessary expenses paid in carrying on his business from his gross income from whatever source.

Article 101 of Regulations 69 is practically the same as the above-quoted article.

As elaborating on and explaining these regulations, the following is quoted from an office ruling published in 1919:

"Business expenses," as defined in article 101, Regulations 45, includes all items entering into what is ordinarily known as the cost of goods sold, together with selling and management expenses. In short, every necessary item of expense in conducting business, incurred primarily because of and solely in the furtherance of the business engaged in, is held to be an ordinary and necessary business expense.

To what extent can this definition of business expenses be applied? Does it include any and all expenses which in any way bear upon or have a relation to or a connection with the business engaged in by the individual? Obviously, amounts paid out for medical attention necessary for the upkeep of the body and the preservation of health are personal and have no connection with business. Likewise, sums paid to the grocer, to the tailor, amounts paid for insurance and house rent. These expenses arise independently of business. The test, therefore, is whether an expense is incurred primarily because of business as the immediate cause inducing the expenditure. (1 C. B. 101.)

The expenditure in this case does not meet with the test laid down in the above-quoted office ruling. It arose independently of the taxpayer's business and was not incurred primarily because of business or as the immediate cause of inducing the expenditure. The expense of protecting one's property, although that property has been acquired by reason of business done in the past, relates to and

arises from *ownership*, not *business*. It is, except for food and shelter, perhaps the purest form of personal expense. The necessity of defending one's reputation is certainly no more a business expense than is the necessity of protecting one's health. Both health and reputation are necessary to the successful conduct of business, whether it be the business of a lawyer, that of a merchant, doctor, or minister of the gospel. It is difficult to conceive of an expenditure more personal than the one here under consideration. The action for an accounting was inspired and brought about because the former law partner of the taxpayer believed that a personal wrong had been committed against him by the petitioner and the defense of the action was undertaken, successfully in this case, for the protection of petitioner's property owned and accumulated, as was shown, outside of his trade, business, or profession, that of practicing law, and for the further defense of his reputation and good name, both of which are entirely personal to the taxpayer and not connected with his trade, business, or profession. The action for an accounting was begun after the partnership had been dissolved, all of its affairs wound up, and the partnership relation had ceased to exist, and regardless of the outcome of the action for an accounting the petitioner's business would have been in nowise affected. If the suit had been lost by the petitioner the result would have been that petitioner's personal fortunes would have been reduced by the amount of the judgment.

The statute requires that expenses to be deductible must be both "ordinary" and "necessary." Neither qualification alone comes within the purview of the statute and does not make an expense deductible. The deduction intended to be allowed is one of the usual or common and essentially a reasonably necessary expense in the case of persons doing a similar kind and volume of business, and, by implication, extraordinary and unnecessary expenditures in the maintenance and operation of a business, are excluded. Thus, in the case of *Chapin* v. *Irwin*, unreported except in 3 Am. Fed. Tax Rep. 3429, a jury found that certain expenses relating to the operation of a farm were not necessary and ordinary because they were very large. In the case of *Laemmle* v. *Eisner*, 275 Fed. 504, the court held that the attorney's fee paid in litigation for control of certain stock, resulting in practically the ownership or control of the company, and the consequent management of the company, was not an ordinary and necessary expense of carrying on business, but was an extraordinary expense properly chargeable to capital account. It would certainly be an unsound contention on the part of the petitioner that the defense of actions of accounting is an ordinary occupation of a lawyer or a usual incident to his business. It is fortunately only an extraordinary and unusual circumstance that necessitates such an expenditure. Yet the defense of this suit for an accounting must be attributable to a purpose to pro-

tect property or to vindicate reputation. The latter is by its expression clearly a personal expense, and the former is not only a personal expense but also a capital expense, the deduction of both of which is expressly forbidden by the statute (Section 215 (a) (b) and (c) of the Revenue Act of 1918).

*Appeal of Hewes*, 2 B. T. A. 1279.

*Appeal of Cons. Mutual Oil*, 2 B. T. A. 1067.

*Appeal of Palmer*, 3 B. T. A. 403.

The statute moreover provides that to be deductible the expense must be incurred in carrying on a business. Merely the facts of the instant case exclude the deduction claimed by petitioner. Defending the action against him was a single isolated transaction, and a loss incurred in such transaction is not deductible. See *Mente* v. *Eisner*, 266 Fed. 161. Here the most that can be said for the taxpayer is that he was put to an expense in winding up or closing out the business. The alleged misappropriation of moneys was not said to have been in the course of his business but in the course of his previously existing partnership business. Whether he won or lost the suit for an accounting filed against him would not affect his present business or its profit, as is demonstrated by assuming that at the dissolution of the old partnership a new one had been formed between the taxpayer and persons other than his former partner. Clearly the new partners would not have benefited or suffered from

the outcome of the suit for an accounting or been called upon to pay any part of the attorney's fee expended in defending said action.

If it be said that the application of the statute as here limited requires a literal interpretation of its words and a refusal to liberalize its provision, the Government will accept the consequences of the premises, although it does not concede that its construction is more than a fair reading of the statute, for this Court has repeatedly said that deductions can not be taken as a matter of right, but that they are in the nature of exceptions which must be strictly construed against allowance and allowed only by express provisions.

It is insisted that the expenditure which plaintiff was seeking to deduct from his gross income for the year 1918 was not an ordinary and necessary expense such as is deductible under Section 214 (a) (1), nor was it a "loss" such as is deductible under subsections (a) (4) or (5) of Section 214, but that said expense is a personal or capital expense which Section 215 (a) expressly provides shall not be deducted from gross income.

The above brief was prepared by the Bureau of Internal Revenue. We are not in accord with its reasoning nor with the conclusion reached by the

Court of Claims, but feel bound to submit the case to this Court for decision. A judgment based on a confession of error would not bind the Court of Claims in other like cases. The Bureau of Internal Revenue believes that the decision of the Court of Claims is right. The provisions of the 1918 Act here in question, relating to the deduction of ordinary and necessary expenses in carrying on business and forbidding the deduction of personal expenses, are found in the more recent Revenue Acts, and the questions what is a personal expense and what is a capital expenditure are constantly arising. There does not seem to be any third class of expenditures between ordinary business expenditures on the one hand and personal expenditures on the other. The expenditure in this case does not seem like a personal expense in any proper sense. It was an individual expense as distinguished from a firm expense, but that is a different matter. We infer that the shares of stock received by petitioner in 1918 were received as compensation for some services performed and that the question between him and his former partner was whether the services were performed during the existence of the law partnership or afterwards, or disconnected with it. If that be so, the value of the shares constituted taxable income and the expenditure of attorney's fees in defending the right to receive and retain that income would have been to enlarge the taxpayer's income subject to income taxes. An ex-

penditure for the purpose of obtaining or retaining taxable income does not seem like a personal expenditure.

We agree with the Court of Claims that the expenditure did not constitute a loss.

If the expense was a business rather than a personal expense, it can hardly be treated as a capital expenditure. While the petition in the Court of Claims is not clear, it may be that the shares of stock received were as compensation for legal or other services. Money expended to obtain or retain taxable income should be treated as a deduction from income and not as a capital expenditure.

We present below further extracts from the regulations of the Treasury and illustrations as to the rulings heretofore made in the Bureau of Internal Revenue on this subject.

*Personal and Family Expenses*, Art. 291, Reg. 45:

> Insurance paid on a dwelling owned and occupied by a taxpayer is a personal expense and not deductible. Premiums paid for life insurance by the insured are not deductible. In the case of a professional man who rents a property for residential purposes, but incidentally receives there clients, patients, or callers in connection with his professional work (his place of business being elsewhere), no part of the rent is deductible as a business expense. If, however, he uses part of the house for his office, such portion of the rent as is properly attributable to such office is

deductible. The father is legally entitled to the services of his minor children, and allowances which he gives them, whether said to be in consideration of services or otherwise, are not allowable deductions in his return of income. Alimony and an allowance paid under a separation agreement are not deductible from gross income. See article 73. The cost of the equipment of an army officer to the extent only that it is specially required by his profession and does not merely take the place of articles required in civilian life is deductible. Accordingly, the cost of a sword is an allowable deduction, but the cost of a uniform is not.

*Capital Expenditures*, Art. 293, Req. 45:

Amounts paid for increasing the capital value or for restoring the depreciated value of property are not deductible from gross income. See section 214 (a) (8) of the statute and article 161. Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architect's services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities are an offset against the selling price. Expenses of the administration of an estate, such as court costs, attor-

ney's fees, and executor's commissions, are chargeable against the corpus of the estate and are not allowable deductions. Amounts to be assessed and paid under an agreement between bondholders or stockholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. See article 543. An assessment paid by a stockholder of a national bank on account of his statutory liability is similarly not deductible.

*Personal Expenses*

The Commissioner of Internal Revenue has ruled the following to be personal expenses:

(1) Amounts paid as damages for breach of promise to marry. C. B. 2, p. 157;

(2) Attorney's fees and other costs sustained by taxpayer in an action for breach of promise to marry. C. B. II–2, p. 61;

(3) Amounts expended in defending a suit for damages alleged to have been caused by the negligent operation of an automobile owned and operated for personal convenience. C. B. 4, p. 159;

(4) Attorney's fees paid by a taxpayer engaged in the retail drug business in connection with a prosecution for illegal sale of narcotics. C. B. 4, p. 209;

(5) Trial expenses and attorney's fees in defending a member of a partnership against criminal charges for violation of the Alien Property Act. C. B. IV–1, p. 170.

**The Board of Tax Appeals has held the following to be personal expenses:**

> **(1) Expense of defending an indictment for perjury growing out of taxpayer's business.** ***Appeal of Sara Backer et al.,*** **1 B. T. A. 214. In this case the Board laid down the following test: "We are dealing here with the age-old question of proximate cause. If the charge of perjury proximately resulted from the business * * * it may be conceded that the expense of defense against that charge was an ordinary and necessary expense of carrying on his business. If, on the other hand, the business of contracting was not proximately related to the charge of perjury, then the cost of defense was not a business expense * * *.**
>
> (2) Expense of defense in proceedings for violation of criminal provisions of the Trading with the Enemy Act. *Appeal of Norvin R. Lindheim,* 2 B. T. A. 229.

*Business Expenses*

The Commissioner of Internal Revenue has held attorney's fees and legal costs in the following cases to be business expenses:

> (1) Expense of defending title to a patent. C. B. 2, p. 105;
>
> (2) Attorney's fees incurred in defending suit for damages by a tenant working on the taxpayer's farm. C. B. 5, p. 121;
>
> (3) Legal expenses incurred by a taxpayer (a doctor) in defending a suit for malpractice in his profession. C. B. V–1, p. 227;

(4) **Attorney's fees and expenses incident to disbarment proceedings instituted against taxpayer, an attorney. C. B. V–1, p. 227; reversing C. B. IV–1, p. 140.**

The Board of Tax Appeals has held legal costs to be business expenses in the following case:

> The cost of an accounting required by court order to be made at the expense of the taxpayer to ascertain the damages resulting from taxpayer's infringement of a patent. *Appeal of Meyer & Bro. Co.*, 4 B. T. A. 481.

*Capital Expenditures*

The Commissioner of Internal Revenue has held the following legal expenses to be capital expenditures:

> (1) Attorneys' fees paid by a nonresident alien in securing the return of property and income from the Alien Property Custodian. C. B. 5, p. 127. In this case it is said: "* * * the mere ownership of property does not constitute 'carrying on' a business within the meaning of the statute, and such legal expenses, therefore, cannot be considered as ordinary and necessary expenses. The attorneys' fees in question should be considered a part of a capital transaction and treated in the same manner as commissions paid in purchasing or selling securities. If the Alien Property Custodian returned property, as distinguished from money, the attorneys' fees should be treated as a part of the cost price of the property. If the Alien

Property Custodian took over property, converted it into cash, and delivered money to the taxpayer, the attorneys' fees constitute an offset against the selling price."

(2) The cost of perfecting or defending title to or reducing an assessment for a local benefit against property. C. B. 3, p. 192. (Defense of enjoyment as well as title to property is included as illustrated by fees paid attorneys to contest the establishment of a building line against property. C. B. I-2, p. 146.)

(3) Cost of contesting a will whereby title and possession of property was obtained. C. B. II-1, p. 122.

The Board of Tax Appeals has held that attorney's fees or other legal expenses are capital expenditures in the following cases:

(1) *Appeal of Charles P. Howes*, 2 B. T. A. 1279. In this case the taxpayer, an individual, held a deed to land acquired by him from the original purchaser at a tax sale. Abutting property owners claimed this land to be a public alley by reason of adverse user. In establishing his title to the land the taxpayer expended $5,250 attorney's fees. The land was subsequently sold. In determining the value of taxpayer's interest in the land as of March 1, 1913, the Board held that the amount expended as attorney's fees was an additional capital expenditure which should be taken into consideration in computing the gain realized from the sale.

(2) *Appeal of Consolidated Mutual Oil Company*, 2 B. T. A. 1067. In this case the taxpayer, a corporation, in its individual tax return for 1918 deducted as an expense $958.30 paid out as reporter's fees in a suit unsuccessfully brought against it by the United States to oust it from the possession of certain oil lands. This amount was held by the Board to be a capital expenditure, rather than a business expense.

(3) *Appeal of Earl M. Palmer*, 3 B. T. A. 403. In this case taxpayer, an individual, took over the milling business of a friend named Stern, who was called into military service, under the terms of a contract which obligated the taxpayer to faithfully manage and continue the business. All the profits during Stern's military service were to be the taxpayer's, but upon Stern's return the taxpayer was to restore one-half of the business to him. When Stern returned, however, the taxpayer refused to carry out the agreement. Litigation for recission of contract and an accounting was instituted by Stern. The case was finally settled out of court, however, by the payment of $25,000 to Stern by the taxpayer, who thereafter continued to conduct the business. The taxpayer claimed deduction of the $25,000 as an expense. In disposing of the case the Board said:

"The question then arises as to whether the amount of $25,000, paid by the taxpayer in 1919 to Stern, constitutes an ordinary and

necessary business expense or a capital expenditure. It was paid to Stern in settlement of litigation over the question as to whether the conveyance and contract made between the parties were effective. The effect of the payment was that the taxpayer acquired the undisputed ownership of the business and became entitled to all profits arising therefrom. The court, if it had followed the recommendation of the master, would have held that the taxpayer had no interest in the business, except the salary which he drew and certain traveling expenses. It would have put the parties back in the same situation they were in while Stern owned and operated the business himself, and the taxpayer would have been required to account for the profits. By making the payment of $25,000 he saved to himself the business and its profits.

"In view of the foregoing facts, we are of the opinion that the said payment amounted to a capital expenditure and was not an ordinary and necessary expense."

The only court decision bearing on the question here under consideration is *Laemmle* v. *Eisner*, 275 Fed. 504. In this case the United States District Court for the Southern District of New York held that attorney's fees paid in litigation for control of certain stock, resulting in practically the ownership or control thereof and the consequent management of the company, constituted a capital investment rather than a business expense. The

opinion of the court is short and does not enter into a discussion of the principles.

Respectfully submitted.

WILLIAM D. MITCHELL,
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SEWALL KEY, *Attorney.*

JANUARY, 1928.

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# SUPREME COURT OF THE UNITED STATES.

No. 162.—October Term, 1927.

Samuel J. Kornhauser, Petitioner,
*vs.*
The United States.
} On Writ of Certiorari to the Court of Claims.

[February 20, 1928.]

Mr. Justice Sutherland delivered the opinion of the Court.

The petitioner sued in the Court of Claims to recover $1,126.15, the amount by which his income tax for the year 1918 was increased by reason of the refusal of the Commissioner of Internal Revenue to allow a deduction from petitioner's gross income of the sum of $10,000 claimed as a business expense for that year. The petition alleges that the latter sum was paid by petitioner for attorney's fees incurred in the defense of a suit against him for an accounting instituted by his former co-partner, said suit growing directly out of the conduct of the partnership business, it being alleged by the co-partner that petitioner had collected fees or compensation for professional services performed during the existence of the partnership to a division of which the co-partner was entitled; that the alleged fees in fact consisted of stock in a corporation acquired subsequently to the dissolution of the partnership and not for services performed during its existence; that the defense to the suit was successful and the amount paid was a necessary expense incurred in connection with petitioner's business within the meaning of § 214(a), subd. (1), of the Revenue Act of 1918, or a loss within the meaning of subd. (4) of the same section; that a claim for refund of the excessive tax was duly made to the Commissioner and by him rejected. To this petition a demurrer was interposed and by the court below sustained and the petition dismissed on the ground that the expenditure was not an allowable deduction under either provision of the statute, but was a personal expense under § 215(a) of the Revenue Act of 1918. 62 C. Cls. 647.

We think it is obvious that the expenditure is not a loss; and the only provisions of the Revenue Act (c. 18, 40 Stat. 1057, 1066, 1069) which need be considered are § 214(a), subd. (1), which reads:

"Sec. 214. (a) That in computing net income there shall be allowed as deductions:

"(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . ."

and § 215(a) which provides:

"Sec. 215. That in computing net income no deduction shall in any case be allowed in respect of—

"(a) Personal, living, or family expenses."

On the case made by the petition the expenditure in question was either a personal expense or a business expense:—it was not a living or family expense. And it was an "ordinary and necessary" expense, since a suit ordinarily and, as a general thing at least, necessarily requires the employment of counsel and payment of his charges. The petition is not as definite as it might have been, but from its allegations, interpreted as the Solicitor General concedes they may be, it appears that the accounting suit presented the question whether the compensation in respect of which the co-partner sought an accounting was for professional services performed by petitioner during the existence of the partnership or after its termination, the defense to that suit being based upon the latter alternative. In either view, the compensation constituted business earnings.

The Solicitor of Internal Revenue in a recent opinion has held that legal expenses incurred by a doctor of medicine in defending a suit for malpractice were business expenses within the meaning of the statute. In the course of the opinion it was said that such expenditures were as much ordinary and necessary business expenses as they would be if made by a merchant in defending an action for personal injuries caused by one of his delivery automobiles, and that in the latter case the deduction would be allowed without question. C. B. V. 1, p. 226.

Another departmental ruling is to the effect that legal expenses incurred in defending an action for damages by a tenant injured while at work on the taxpayer's farm are deductible as a business expense. C. B. 5, p. 121.

In the *Appeal of F. Meyer & Brother Co.*, 4 B. T. A. 481, the Board of Tax Appeals held that a legal expenditure made in defending a suit for an accounting and damages resulting from an alleged patent infringement was deductible as a business expense.

The basis of these holdings seems to be that where a suit or action against a taxpayer is directly connected with, or, as otherwise stated (*Appeal of Backer*, 1 B. T. A. 214, 216), proximately resulted from, his business, the expense incurred is a business expense within the meaning of § 214(a), subd. (1), of the act. These rulings seem to us to be sound and the principle upon which they rest covers the present case. If the expense had been incurred in an action to recover a fee from a client who refused to pay it, the character of the expenditure as a business expense would not be doubted. In the application of the act we are unable to perceive any real distinction between an expenditure for attorney's fees made to secure payment of the earnings of the business and a like expenditure to retain such earnings after their receipt. One is as directly connected with the business as the other.

*Judgment reversed.*

A true copy.

Test:

*Clerk, Supreme Court, U. S.*

END

OF

CASE